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How Do You Ensure Value for Money in an Outsourcing Relationship?

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A company embarking on an outsourcing project will often identify cost reduction and value for money as key drivers for the outsourcing. Service providers will usually tout their value for money in their pre-sales materials. But in practice, companies often discover that, although they may be happy with the price that was originally quoted during the initial tender exercise, keeping aligned with value for money standards is more difficult.

So what mechanisms can be built into an outsourcing relationship to help keep the price competitive over the life of the contract, once the leverage of the tender process has disappeared? Here's a list of 10 common mechanisms that can be used to focus on keeping continued value for money at the heart of the outsourcing relationship.

Benchmarking

Benchmarking provisions typically give the customer a right to require that the charges (and potentially other service aspects, such as SLA performance) are compared with the market by an independent third party benchmarker. The likely success of benchmarking as a tool to achieve value for money depends on the degree of standardisation of the outsourced services: *i.e.*, effective benchmarking is harder for more customised services. For that reason, in large outsourcing projects customers often choose to break down the services into distinct service lines and institute a rolling programme of benchmarking over, say, 2 year cycles.

Benchmarking only really works in longer term relationships. In contracts of less than 3 to 5 years duration, most companies feel that there is little point in benchmarking. Conversely, in "evergreen" or rolling-term contracts, the periodic roll-overs are likely to be directly linked to some value for money review mechanism such as benchmarking.

The contract should, of course, detail the benchmarking mechanism. For example, the parties should consider very carefully which organisations should form the analysis group to avoid any disagreements later on. The contract should also be clear as to what the consequences of any benchmark will be. In order for the benchmarking to have teeth, the customer would typically seek a mandatory price reduction, and/or a right to terminate the contract, if the benchmark identifies that the charges are too high – maybe with a tolerance. However, the service provider will resist this. The customer will have to be realistic when negotiating the benchmarking mechanism and remember that any right to benchmark is a useful practical trigger to re-negotiate the contract.

Gain-share

Gain-share mechanisms come in a number of different forms. At its simplest, a gain-share clause will ensure that economies or improvements made by the service provider are passed on (or, at the very least, shared) with the customer. Gain-share clauses can work around target profit margins – *i.e.*, ensuring that any "super-profits" above the expected level are shared, as opposed to being all for the service provider's benefit. Or the mechanism can address productivity efficiencies (*e.g.*, on software development work), or simply positive shifts in the service provider's cost base.

Whatever the agreed triggers, well constructed gain-share mechanisms are in vogue as a way to incentivise service providers to make improvements and to share the benefits of those improvements.

Right to Market Test

Companies ought to consider carefully their rights to market test individual service line elements at any point in time if they have concerns at the on-going value for money of the outsourcing charges.

Service providers will argue that this is inconsistent with the exclusive nature of an outsourcing relationship – but who ever said that an outsourcing contract always has to be exclusive? Sure, one would usually want to stick with one primary provider of services, but new service requirements that come along should certainly be capable of being sourced elsewhere. And companies should have the right to market test existing services periodically if they choose.

That leads to a debate about the cost impact if a market test leads to the eventual removal of a service line and whether there is a threshold level below which services cannot be removed without rendering the contract uneconomic. But those are implementation issues and shouldn't affect the existence of the underlying right to run a checkpoint on value for money by a market test.

Onshore/Offshore Mix

One of the key drivers for offshoring a function will be to receive the benefit of competitive labour costs. Where the customer's business case is based on an expected level of offshoring, the contract should detail the expected mix of onshore/offshore resource, and the customer should consider the consequences if the service provider does not achieve that mix. For example, should the customer receive a credit reflecting the difference between the charges that would have been charged had the split been achieved and the amounts that were actually charged due to the actual onshore/offshore mix?

Items/Component Pricing

The customer should ensure that the contract specifies how price reductions in the costs of items/components will be reflected in the charges. It's possible to link this back to benchmarking (which, of course, doesn't have to be a nuclear end-to-end device: it can operate at component level) – and reserve the right for a third party expert to assess the efficiency of a service provider's own sourcing of its input resources to ensure that the service provider is kept on its toes to achieve value for money in component pricing.

And companies should certainly reserve the right to audit, supervise or even participate in their outsourcer's own input sourcing or procurement exercises in order to make sure that the value for money ethos flows down to the sub-contractor selection level.

Indexation

The customer must carefully consider whether to agree to any form of indexation mechanisms. In particular, when offshoring a service, the customer should seek to cap the level of wage inflation that forms part of any indexation measure. Outsourcing providers service lots of customers and should be better placed than individual customers to hedge inflation risk.

Additional Costs

In order to avoid any opportunity for the service provider to claim that additional charges are payable, at the most basic level the customer should ensure that the contract:

- has a sufficiently detailed specification of services;
- allows for flexibility and changes in the services/operations;
- identifies who will bear the costs of changes in law and regulation; and
- clearly details any exit costs payable by the customer.

If these costs are not taken into account, the customer may find out that the charges are not as competitive as it originally thought. An outsourcing contract ought to make it clear that there are no hidden charges and the service provider can only charge for items expressly specified in the Charges Schedule.

Value for Money Report

The customer may also require the service provider to prepare an annual value for money report which involves the service provider reviewing the service charges and service levels against market comparators, and comparing the actual market position of the services charges and service levels against the agreed market position (*e.g.*, the customer may have agreed up-front with the service provider that it only requires charging levels or service performance to fall within the second quartile across the industry, as it is not prepared to pay the services charges necessary to ensure first quartile performance). The report would then trigger discussions between the parties through the governance process as to what steps (if any) should be taken by the parties in response to the report findings.

Pass-though Charges

Pass-through charges are out-of-pocket expenditure by the service provider that are incurred in providing the services and then passed on to the customer, possibly with a mark-up. In most cases, customers will want the service charge to be all-in, without pass-through charges. Consider carefully any suggested pass-through – and especially any margins added on top and the rationale for the suggested margin.

Most Favoured Customer

Historically, customers tried to achieve price competitiveness over the life of the contract with the "most favoured customer" (MFC) clause (*i.e.* the service provider will not sell the same/similar products or services to anyone else for a cheaper price), which was an old friend imported from commodity-type procurement contracts.

Although attempts to include MFC clauses are still occasionally seen in outsourcing projects, and may be tempting, companies mostly now realise that these clauses are almost impossible to enforce in an environment where normalising between different sets of services and different customers is very difficult. In reality, MFC clauses still only really belong in the realm of commodity purchases.

Conclusion

Customers may take it as read that outsourcing will bring them immediate cost savings and on-going cost efficiencies over the contract term. However, the contract must include the right mechanisms and the customer must ensure it is firm in its contract management of the service provider, to ensure that those cost savings can be realised. Most outsourcing contracts recognise that there's no single magic bullet and therefore contain a mix of different mechanisms – including those set out above - designed to ensure continuing value for money.